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(Article)

## How NRIs Can Avoid Paying Taxes on Mutual Fund Investments

### Leveraging DTAA Benefits

For Non-Resident Indians (NRIs), investing in Indian mutual funds can be both a lucrative and strategic financial move. However, **taxation on investment returns** is often a point of concern. **Double Taxation Avoidance Agreements (DTAAs)** can significantly reduce or even eliminate the tax liability on capital gains, depending on the investor's country of residence. Understanding the intricacies of DTAA is critical to making informed decisions and optimising post-tax returns.

#### ► Understanding Double Taxation and DTAA

Double taxation arises when the same income is taxed twice—once in the source country where it is earned, and again in the resident country where the taxpayer resides. Countries generally tax income based on two principles:

**Residence Rule:** Income is taxed in the country where the individual resides.

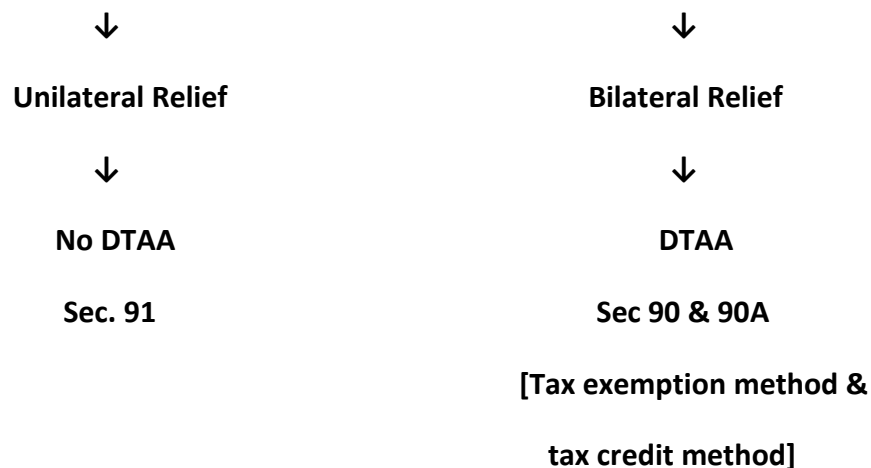
**Source Rule:** Income is taxed in the country where it originates.

When an NRI earns income in India but resides in a different country, both jurisdictions may assert the right to tax the same income. To mitigate this, countries enter into Double Taxation Avoidance Agreements (DTAAs), which are bilateral treaties designed to ensure that the income is taxed only once or that credit is given for taxes paid in one country against the liability in the other.

## ► Types of Double Taxation Relief

There are two primary mechanisms to grant relief from double taxation:

### ► There are two type of Double taxation relief



**Unilateral Relief** - (Section 91 of the Indian Income Tax Act): This applies when there is no DTAA between India and the other country. India offers unilateral relief to residents who have paid taxes in the source country.

**Bilateral Relief** - (Section 90/90A): This is applicable when India has entered into a DTAA with another country. Relief is granted through either of the **following methods**:

**Exemption Method**: Income is taxed only in one country, typically the source country.

**Tax Credit Method**: Income is taxed in both countries, but **credit is provided in the country of residence** for the tax paid in the source country.

**\*\* India primarily follows the tax credit method in most of its DTAA's.**

## ► DTAA and Mutual Fund Taxation: A Case Study with the UAE

Under the DTAA between India and the United Arab Emirates (UAE), **capital gains fall** under a **residual clause** which assigns the **right to tax capital gains to the country of residence**. Since **the UAE does not levy capital gains tax on individuals**, NRIs residing in the **UAE are not liable to pay capital gains tax on mutual fund investments in India**.

### ► CASE STUDY:

Mr. A, an NRI residing in the UAE, invests ₹50,000 per month via a Systematic Investment Plan (SIP) in Indian equity mutual funds. Over 20 years, assuming an annual return of 12%, his investment corpus grows to ₹4.59 crore. His capital invested is ₹1.2 crore, and the capital gains amount to ₹3.39 crore.

As per the **India-UAE DTAA**, the **capital gains are taxable only in the UAE**, which does not tax such income. Consequently, **Mr. A enjoys tax-free returns on his Indian mutual fund investments**, significantly enhancing his effective post-tax yield.

## ► Essential Compliance to Avail DTAA Benefits

Merely residing in a DTAA-partner country does not automatically entitle an NRI to tax exemptions. The following compliance is essential:

### **Tax Residency Certificate (TRC):**

As mandated under Section 90(4) of the Income Tax Act, a TRC must be obtained from the foreign government, confirming the taxpayer's residency in that country. Indian tax authorities accept the TRC as sufficient proof and do not re-evaluate the residential status.

### **Form 10F and Other Prescribed Details:**

In addition to the TRC, the assessee must furnish Form 10F along with the following information:

- ❖ Status of the assessee (individual, company, etc.)
- ❖ Permanent Account Number (PAN) if allotted
- ❖ Nationality (for individuals)
- ❖ Country of incorporation (for entities)
- ❖ Tax Identification Number (TIN) or equivalent
- ❖ Duration of residency in the certificate
- ❖ Residential address abroad

**\*\* If the TRC already includes these details, Form 10F may not be necessary.**

### ➤ **The Principal Purpose Test (PPT): Anti-Avoidance Provision**

With evolving international tax frameworks, **many DTAA's now incorporate the Principal Purpose Test (PPT) to counter treaty abuse.** Under this test, if it is evident that **the main objective of an individual relocating to a tax-favorable jurisdiction is to avoid taxes, the benefits of the DTAA may be denied.**

For instance, if a person shifts base to the UAE shortly before selling Indian mutual fund investments purely to claim DTAA benefits, **Indian authorities could invoke the PPT to nullify the tax exemption.**

### ➤ **Countries Offering Favorable DTAA Benefits for NRIs**

Several countries have DTAA's with India that offer exemptions on capital gains tax through residual clauses. Notably:

- ❖ United Arab Emirates (UAE)
- ❖ Singapore
- ❖ Mauritius

➤ **NRIs residing in these countries can potentially enjoy complete tax exemption on capital gains arising from Indian mutual fund investments.**

## **Countries Where India Retains the Right to Tax Capital Gains**

Conversely, India maintains taxing rights under its DTAA's with several other nations. NRIs residing in these countries are liable to pay capital gains tax in India despite the existence of a DTAA. Examples include:

- ❖ United States of America
- ❖ United Kingdom
- ❖ Canada

➤ ***In such cases, mutual fund capital gains are taxable in India, and the investor may be eligible to claim credit for the Indian taxes in their country of residence, subject to domestic tax laws.***

## **Conclusion**

DTAA's present a valuable opportunity for NRIs to optimise their tax liability on mutual fund investments in India. Strategic residency planning, proper documentation, and adherence to compliance requirements are key to availing these benefits. While countries like the UAE, Singapore, and Mauritius offer highly favorable DTAA provisions, others such as the U.S., U.K., and Canada do not exempt capital gains, requiring more comprehensive tax planning.

Professional advice from a qualified chartered accountant is highly recommended to ensure compliance and to maximize post-tax returns, especially in light of evolving global tax laws and anti-abuse regulations such as the Principal Purpose Test.

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